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LIQUIDATED DAMAGES IN ILLINOIS CONTRACTS

Liquidated damages are a sum which a contracting party agrees to pay, or a deposit which he agrees to forfeit, if he breaches some promise. The stipulated amount must have been arrived at by a bona fide effort to estimate in advance the actual damage which would probably result from the breach in order to be recoverable or retainable as agreed damages if the breach occurs. Frequently, what would appear to be a liquidated damages provision in a contract is held to be a penalty. A *penalty* is also a sum which a party agrees to pay or forfeit in the event of a breach. The difference lies in that in the case of a penalty the stipulated amount is fixed, not as a bona fide estimate of actual damages, but as a punishment, the threat of which is calculated to prevent a breach. Where such a provision is held to be for a penalty, rather than for liquidated damages, it is void, and the party seeking to collect damages is limited to those actual damages which he is able to prove.¹

Most first year law students who have studied Contracts are aware of the rule that a liquidated damages clause is enforceable only if it provides, in fact, for liquidated damages, and not for a penalty. Nevertheless, they probably would encounter difficulty in attempting to explain with any degree of particularity the criteria or standards to be utilized in judging the validity of an apparent liquidated damages provision. They need not feel alone, however, for the courts have also been thwarted:

This court has said more than once that no branch of the law is involved in more obscurity by contradictory decisions than whether a sum specified in an agreement to secure performance will be treated as liquidated damages or a penalty and that each case must depend upon its own peculiar and attendant circumstances, and that therefore general rules of law on this subject are very often of very little practical significance.²

Merely in order to emphasize the frustrating nature of the topic, it should be noted that in espousing the vagaries of the subject, the judge in the quoted material referred to "a sum specified in an agreement to secure performance" as either liquidated damages or a penalty. Technically, this is incorrect because "a sum specified . . . to secure performance" is by definition a penalty.

The purpose of this article is to attempt to explore those standards or criteria which the courts have applied in resolving issues pertaining to liquidated damages. As a precaution, one would do well to remember that frequently the courts have done little else than state conclusions with little or no explanation as to how such were deduced.

¹ McCormick, *Damages* § 146 (1st ed. 1935).

² Giesecke v. Cullerton, 280 Ill. 510, 513, 117 N.E. 777, 778 (1917).

THE NEED FOR JUDICIAL INTERFERENCE

For many years it has been the policy of the courts to constitute themselves the guardians and protectors of the individual who, though competent to contract, has entered into an improvident agreement to pay an exorbitant sum of money in event of his default in some respect which does not, in fact, cause anything like equivalent damage to the other party. Such a provision is called a penalty, and the courts refuse to enforce it.³

As a preliminary matter, some consideration should be directed to the question of why the judiciary has felt compelled to concern itself with the validity or invalidity of liquidated damages clauses. After all, if a party knowingly promises that he will pay a certain sum in the event he breaches his contract, why should he be able to "worm" his way out of fulfilling that promise at a later date? Actually, the cases discuss this matter little or not at all. However, one may speculate with some degree of certainty as to the reasons behind the rule. Initially, the fundamental aim of damages is to compensate an injured party for the harm caused him by another's breach of duty, and in the case of contract damages specifically to put him in the place he would have been had the contract been performed. Except in rare cases involving exemplary damages, punishment of the injuring party is not the goal. Consequently, it follows that contracting parties should not be able to accomplish by agreement that which the law has declined to permit, *i.e.*, punishment of the defendant. Secondly, the rule is probably aimed to protect those overly zealous individuals who agree to pay liquidated damages largely because their exuberance does not allow them to foresee the possibility of their breaching. Finally, the courts probably feel that oftentimes such clauses have been the product of situations wherein the parties had a significantly disproportionate bargaining power and in other respects resembled circumstances attendant adhesion clauses.

LIQUIDATED DAMAGES CLAUSES GENERALLY

In general, in order for a provision for payment of a stipulated amount incident to a breach of contract to be deemed one for liquidated damages, it is necessary that the damages contemplated from a breach be uncertain and difficult of ascertainment;⁴ that the parties intended to liquidate them in advance;⁵ and that the sum provided for is reasonable,⁶ *i.e.*, it bears some relation to the presumable loss or injury.⁷ The question as to whether a contract clause provides for liquidated damages or a penalty is a question of law. In resolving the issue, the court will normally look to the contract

³ *Burnett v. Nolen*, 336 Ill. App. 376, 379, 84 N.E.2d 155, 156 (4th Dist. 1949).

⁴ *Gibb v. Merrill*, 234 Ill. App. 267 (2d Dist. 1924).

⁵ *Burnett v. Nolen*, *supra* note 3; *Gibb v. Merrill*, *supra* note 4.

⁶ *Parker-Washington Co. v. City of Chicago*, 267 Ill. 136, 107 N.E. 872 (1915); *Christian Mills v. Berthold Stein Flour Co.*, 247 Ill. App. 1 (1st Dist. 1927).

⁷ *Gibb v. Merrill*, *supra* note 4.

as a whole and also consider the facts and circumstances surrounding the making of the contract.⁸

THE UNCERTAINTY OF ASCERTAINING DAMAGES

In *Parker-Washington Co. v. City of Chicago*,⁹ Parker had contracted to lay three foundations for a pumping station and to complete the work by December 22, 1909. The contract provided that in the event Parker failed to complete the work on time, the sum of \$50 for each day it was late would be deducted from the contract price. Parker completed the work 73 days after the stipulated completion date and the city withheld \$3650 in accordance with the contract provision. Parker brought an action to recover this amount, contending that the provision was void as a penalty. In upholding the validity of the clause, the court said that there could be no doubt as to the uncertainty of damages. The pumping station was for the benefit of private citizens. In the event of a failure to complete it on time, no injury would result directly to the city. However, injury would doubtless occur to those for whose benefit the station was being built. A water shortage would increase the threat of fire and in other ways make living less enjoyable for the people in the neighborhood affected.¹⁰ Who could reasonably calculate with any degree of certainty the extent of such injury?

Contracts for the sale of land also lend themselves to valid liquidated damages clauses because of uncertainty of ascertaining damages. For example, in *Gibb v. Merrill*,¹¹ defendant contracted to sell real property to plaintiff for \$7800. The contract provided that in the event of a failure by the seller to convey that he should pay the buyer \$800 as liquidated damages. In an action by plaintiff to recover this amount, the court upheld the clause because, *inter alia*, of the impossibility of determining the extent of injury suffered by virtue of being deprived of the particular plot in question.¹²

McCormick in his work on Damages points out that too much stress should not be placed on the uncertainty of ascertaining damages factor in predicting the validity of a provision for stipulated damages.¹³ He explains that, except in case of a promise to pay money, and sometimes even in that situation, it is very difficult to anticipate with any degree of exactness the damages which will arise from a breach of *any* contract. Consequently, there are very few instances where courts have refused to enforce stipulated damages provisions on the ground that actual damages would be easily ascertainable. He notes that in most cases the courts have relied on the fact that the

⁸ *Giesecke v. Cullerton*, 280 Ill. 510, 117 N.E. 777 (1917).

⁹ *Supra* note 6.

¹⁰ *Id.* at 140-1, 107 N.E. at 874-5.

¹¹ 234 Ill. App. 267 (2d Dist. 1924).

¹² *Id.* at 274.

¹³ McCormick, Damages § 148 (1st ed. 1935).

amount agreed to be paid was grossly disproportionate to the actual loss in refusing to enforce such provisions.¹⁴

THE INTENTION OF THE PARTIES

Another controlling factor in determining whether a stipulated sum is a penalty or liquidated damages is the intention of the parties.¹⁵ For where the claim fixing the amount of damages appears to have been inserted mainly to secure prompt performance of the agreement it will be treated as a penalty.¹⁶

In *Van Kanel v. Higley*,¹⁷ the defendant had contracted to build a house for the plaintiff and "to forfeit and pay . . . as liquidated damages the sum of \$600."¹⁸ if he failed to complete the work by a set date. The defendant breached the contract, but refused to pay the \$600, contending it was a penalty. Referring to the problem of determining when a clause is for liquidated damages and when it is for a penalty, the court said:

Much of the trouble encountered in harmonizing the authorities upon this point will disappear, if we will remember that the real intention to be sought for is whether or not the parties, after having mutually and in good faith considered and calculated the actual damages, intended the sum fixed by this contract to be accepted as compensation for breach of the contract, or merely as security or penalty for the breach thereof.¹⁹

In holding the clause in issue to be a penalty, the court emphasized the use of the word "forfeit" and the fact that the \$600 could not be viewed as damages for delay since a flat amount of money was to be paid regardless of whether the defendant was one day late or two months behind. These facts indicated that it was the intention of the parties to impose a penalty in order to secure performance.

As was noted in the *Van Kanel* case, the language used in the provision itself is often a very significant indicator of the parties' intention. *County of Mercer v. Stupp Bros. Bridge & Iron Co.*²⁰ illustrates the point clearly. Stupp Bros. contracted to build a bridge across a stream for the county and agreed to pay "a penalty" of \$5 for each day the bridge was not completed after January 1, 1903. Stupp Bros. finished the bridge twenty days late. The county withheld \$100 from the contract price in accordance with the liquidated damages clause. Stupp Bros. claimed the provision was invalid as a penalty and brought an action to recover the \$100. The county sought to

¹⁴ *Ibid.*

¹⁵ *Hennessy v. Metzger*, 152 Ill. 505, 514, 38 N.E. 1058, 1060 (1894).

¹⁶ *Scofield v. Tompkins*, 95 Ill. 190 (1880).

¹⁷ 172 Ill. App. 88 (1st Dist. 1912).

¹⁸ *Id.* at 90.

¹⁹ *Id.* at 91.

²⁰ 115 Ill. App. 298 (2d Dist. 1904).

prove that the sum provided for was not a "penalty," notwithstanding the language employed. The court held that the county was bound by the word "penalty." Thus, it would appear that although it may be demonstrated that a clause which provides for "liquidated damages" is, in fact, for a penalty, the reverse is not true, *i.e.*, if the clause reads "penalty," one is not permitted to show that liquidated damages was intended.

It has been seen that mere usage of the words "liquidated damages" in the contract provision in issue does not irrebuttably demonstrate that it was the intention of the parties to liquidate damages rather than impose a penalty. On the other hand, the words "penalty" and "forfeit" conclusively show an intention to impose a penalty. In *Arco Bag Co., Inc. v. Facings, Inc.*,²¹ a third situation was presented, namely, where the parties used none of the aforementioned words. Under a contract clause labelled "Miscellaneous," Arco was given the right to repossess four lift trucks which it had leased to Facings upon any default in payment of rent. In addition, the entire amount of the contract was to become due immediately. Facings failed to make a rent payment and Arco sought to recover the entire amount of the lease, claiming that the "Miscellaneous" clause provided for liquidated damages. In rejecting Arco's contention, the court said:

[T]he failure to use such language (the contract did not mention "liquidated damages") is a factor in determining whether or not the parties actually intended a liquidated damages provision. The contracts in the instant case are devoid of language suggesting that liquidated damages were within the contemplation of the parties under the terms of the contracts.²²

Thus, while the words "liquidated damages" in the contract are inconclusive as to intent, failure to use them may indicate that it was not the intention of the parties to liquidate damages.

REASONABLENESS OF THE SUM PROVIDED

In order for a liquidated damages clause to be valid, it must appear that the amount stipulated is, viewed as of the time of contracting, reasonably proportioned to the probable loss which will ensue from a breach.²³ In *The Standard Brewery v. Johnston*,²⁴ a saloon keeper and a brewing company had entered a contract whereby the former agreed for five years to purchase all his domestic beer from the latter and not to sell or lease the saloon to anyone who did not enter a similar agreement. The contract contained a \$1000 liquidated damages clause. Six months before the end of the five year period, Johnston sold or rented the saloon to a person who had not made an agreement with Standard Brewery. The latter brought an

²¹ 18 Ill. App. 2d 110, 151 N.E.2d 438 (1st Dist. 1958).

²² *Id.* at 117, 151 N.E.2d at 441.

²³ McCormick, *Damages* § 150 (1st ed. 1935).

²⁴ 191 Ill. App. 5 (1st Dist. 1914).

action based on the liquidated damages provision to recover the \$1000. The stipulated sum was construed as having been intended as a penalty because the contract was to run for five years and, therefore, the damages which would result would depend on the time of the breach. Consequently, to exact the sum provided for in the case of a breach occurring shortly before the expiration of the contract would be oppressive and unconscionable. In other words, the stipulated sum could not be said to be reasonably proportioned to the probable loss which would result in the event of a breach because no consideration was accorded the fact of when a breach might occur.

The fact that a liquidated damages clause may provide for an unreasonable sum also indicates that it was the intention of the parties to impose a penalty. In *Lu-Mi-Nus Signs v. Jefferson Shoe Stores*,²⁵ the sign company brought a contract action against Jefferson and sought to recover the amount stipulated in a liquidated damages clause. Jefferson contended that the clause was invalid. The court upheld the clause, but said:

If defendant had introduced evidence showing that the actual damages were considerably smaller than the amount stipulated, this could be regarded as an indication that the amount named was intended as a penalty. . . .²⁶

Thus, it would appear that while the stipulated sum is to be tested as to reasonableness of amount from the viewpoint of the consequences the parties could foresee at the time of contracting, the fact that the fixed sum far exceeds actual damage caused by a breach would indicate that their original effort to estimate damages was not bona fide.

MULTIPLE COVENANTS

The general law where multiple covenants are present was defined in *Iroquois Furnace Co. v. Wilkin Mfg. Co.*,²⁷ where the court said:

Another rule of construction is that, where an agreement contains several stipulations of various degrees of importance, as to some of which the damages might be considered liquidated, while the damages for the nonperformance of the others are not measurable by an exact pecuniary standard, and a sum of money is made payable in gross for a breach of any of them, such sum is held to be a penalty only, and not liquidated damages.²⁸

In *Steer v. Brown*,²⁹ Steer agreed to purchase Brown's hardware business. Brown agreed to pay the inventory taxes on his stock for the year 1900, to lease the premises to Steer for three years, and not to compete in the city of Wyoming for a prescribed period of time. In the event of a breach of the con-

²⁵ 257 Ill. App. 150 (1st Dist. 1930).

²⁶ *Id.* at 155.

²⁷ 181 Ill. 582, 54 N.E. 987 (1899).

²⁸ *Id.* at 603, 54 N.E. at 994.

²⁹ 106 Ill. App. 361 (2d Dist. 1903).

tract by either party, the other was entitled to \$1000 as liquidated damages. Brown breached the contract, but refused to pay the \$1000, claiming the clause provided for a penalty. The court ruled for Brown, citing the *Iroquois Furnace* case. It said that if Brown had breached the provision that he was to pay the inventory taxes for the year 1900, the amount of damages would be only \$20 or \$30, *i.e.*, the amount of the tax. Surely, Steer could not sue for \$1000 for such a breach and seriously expect to recover. A clause cannot provide for both liquidated damages and a penalty; it must be one or the other. Since the clause provided for a penalty, in that it would have required Brown to pay \$1000 for a breach causing only \$20 or \$30 injury, it was a penalty as a whole.³⁰

EXCLUSIVENESS OF REMEDY

If the liquidated damages provision is valid, the damages stipulated fix the upper limit of recovery, *i.e.*, the plaintiff cannot ignore it and seek to prove greater actual damages. Obviously, if the clause is invalid, an injured party may only recover those actual damages which he is able to prove.

A question has arisen as to whether or not a plaintiff may seek a different form of redress than damages when a breach occurs and the contract provides for liquidated damages. In the absence of a valid provision limiting the injured party to this singular remedy, he may apparently pursue other legal remedies. For example, in *Bauer v. Sawyer*,³¹ a medical partnership contract was executed. It provided that in the event one of the doctors elected to withdraw, he agreed not to practice medicine within a 25 mile radius of Kankakee for a period of five years. If the withdrawing partner breached this covenant, ". . . he shall forfeit any unpaid portion of the purchase price of his interest."³² Sawyer quit the partnership and breached the covenant. The remaining partners sought an injunction to restrain Sawyer to abide by the terms of the restriction. Sawyer argued that the clause in the contract provided for liquidated damages and that this was an exclusive remedy. In granting the injunction, the court stated that even if the provision in question were construed as one for liquidated damages (the court said it was a penalty), the right to an injunction was not barred because ". . . the entire agreement indicates the intention of the parties that the covenant . . . be enforced."³³

THE UNIFORM COMMERCIAL CODE

Section 2-718 of the Uniform Commercial Code is concerned with the validity of liquidated damages clauses. While other sections of the Code introduce changes from the doctrines and rules of the common law, the

³⁰ *Id.* at 365.

³¹ 8 Ill. 2d 351, 134 N.E.2d 329 (1956).

³² *Id.* at 354, 134 N.E.2d at 331.

³³ *Id.* at 358, 134 N.E.2d at 332-3.

liquidated damages section is merely a codification of the common law on the subject. A reading of subsection (1) makes this apparent:

(1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.³⁴

Thus, it is probably reasonable to assume that the courts, in applying the Code, will continue to experience as much difficulty as they did under the common law.

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³⁴ Ill. Rev. Stat. ch. 26, § 2-718 (1967).